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From International Corporate Tax Neutrality to Efficient Investment Policy and its Implication on the Desirable International Tax Policy

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The Bhopal Disaster

- In 1984 a factory owned by Carbon United India Limited exploded in the city of Bhopal in India.
- More the 20,000 people have died, more then 500,000 people were injured, and the land and water in the area is corrupted to this day.
- Carbon United India Limited was a subsidiary of Union Carbide Corporation, almost 50% held by non Indian residents, and distributed its profit.
- The alarming outcome I – how can there be a situation in which there is a corporation with negative social value, and a positive value for its investors?
- The alarming outcome II – how can there be a situation in which a business venture has a negative utility to one country, while another country profits from it.

The Corporate Paradox

- limited liability is an efficient mechanism to enable large scale business ventures
- Yet, limited liability has a dark side as well – the limited liability structure cause investors to not take into account risks beyond their initial investment
 - Hansmann and Krakman
 - Bebchuk and Fried
- The residual claimer assumption and its failure
 - Dividend distribution and stock repurchase
 - Interest payments and securities
- The two layered externality of the limited liability

The Corporate Paradox II

- First layer:
- the utility function of the corporation from a social welfare perspective is:

$$R * P - L(1 - P)$$

- The stakeholders' utility function will be:

$$R * P - I(1 - P)$$

- Therefore, the externality is:

$$R * P - L(1 - P) - (R * P - I(1 - P)) = \\ (1 - P)(I - L)$$

- The second layer of the externality is:

$$D(1 - P)$$

- The failure of the corporate law to address the two layer externality
- Corporate tax as a Pigovian tax
- What is the relationship between corporate tax and income tax?

From the National to the International Markets

- Worldwide efficiency Vs. Nation efficiency
 - Is worldwide efficiency a normative goal?
 - The normative problem of cooperation
 - International tax law and the nexus of treaties
- the underlining assumption of the neutrality theories - the efficient tax policy is one that reduce the distortions in the corporate decision making, and the question is how one creates a tax system with minimal distortions, in a world with no full cooperation between countries.
- efficient allocation of capital
 - CEN Vs. CIN
- Efficient allocation of ownership (CON)

Why “tax” neutrality?

- The literature focus on tax neutrality, skipping the fundamental question – why only tax.
- Country A which collect 50\$ of tax, is equivalent to country B, which collect 100\$ of tax and grants a subsidy of 50\$, and country C, which collect 100\$ tax but the liability of the corporation in torts within in is lower and reduced the cost of conducting business by 50\$.
- Three levels of competition
 - Tax
 - Subsidy (direct or indirect)
 - regulation

Why Tax “neutrality”?

- **Race to the Top Vs. Race to the Bottom**
- The assumption - every countries can undercut the tax rate of other countries in order to expand the tax base and therefore maintain the same revenue or even increase it.
- The Benefit theory and the race to the top argument
 - lack adjustment for markets failures
 - Tax and regulation gaming
- The classic race to the bottom argument and its failure
 - Corporate tax is aimed also for redistribution?

The base of the cross border externality problem

- when exporting capital, a country loses some revenue (in a territorial system the entity level tax revenue and in worldwide system the FTC) but maintains the profit for the individual shareholders and the revenue from taxation of interest and dividends. At the same time, it reduces both the direct costs of the business (for example the burden on the roads) and the indirect costs such as the costs of externalities on tort creditors or the environment.

The first cross border externality problem

- Tax is not just about redistribution.
- The supply of pure and partial public goods require coercion.
- Example: assume building and maintaining an airport cost 1,000,000\$ per year for the life time of the airport + 100 \$ per plain. In there is competition, the price will drop to 100\$,and the country supplying the public good will not be compensated for it.
- The sub-optimal investment in public goods cannot be solved unilaterally.

The Second Cross Border Externality Problem

- Is there a race to the top concerning externalities?
- Two types of externalities: activity based and structural based.
- Activity based externalities, such as pollution and noise, should be directly regulated or taxed.
- If we perceive the corporate tax as a Pigovian tax, how can one country bear all the risk, and another collect the revenue?
 - The second cross border externality problem under a residency based taxation.
 - The second cross border externality problem under a territorial based taxation.

Towards a Pure Source Tax

- Why do we focus only on entity level taxation?
- The principles of pure source tax:
 - Taxing at source both at entity level and distribution level (the Brazil model).
 - Redefining source as the place to which the externalities of the limited liability are allocated.
 - The corporate tax rate should not be influenced by redistributive goals (?)
- What is wrong with BEPS and how should the transfer pricing problem be addressed?
- Does Pure Source Taxation requires cooperation? (No)

Thank You

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